MANITOBA INDUSTRY, TRADE & TECHNOLOGY

DISCUSSION PAPERS ON FREE TRADE

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DISCUSSION PAPER

# MANITOBA'S INTEREST IN AND ATTITUDE TOWARDS A PROPOSED CANADA-UNITED STATES FREE TRADE AREA

A Study Prepared for Manitoba Industry, Trade and Technology

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The views expressed in this paper are those of the author. They do not necessarily reflect the views of Manitoba Industry, Trade and Technology.

# Manitoba's Interest in and Attitude Towards a Proposed Canada-United States Free Trade Area

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There is a serious possibility that the Canadian Government may soon begin negotiations with the United States Government aimed at the formation of a comprehensive trade treaty leading gradually to the removal of almost all tariff and non-tariff barriers between the two countries. The desirability of such an arrangement has been supported on a number of grounds. These include:

(1) Canada could expect to obtain a gain in real income in the range of 3 to 8 percent of GNP. This gain would derive partly from the traditional gains related to comparative advantage. But more important in the Canadian context are believed to be the gains obtained from our ability to take greater advantage of the economies of scale offered by our access to the large U.S. market. It is anticipated that many Canadian manufacturers would re-organize their production towards greater specialization involving fewer product lines. These changes could yield substantial productivity gains.

(2) Because the latest (Tokyo) round of tariff reductions under GATT, which are currently taking effect and are to be completed by 1987, have brought tariffs down to fairly low levels, Canadian manufacturers face the prospect of adjusting to these reductions by investing in new facilities. One of their options may be to build new plants in the United States or expand their existing American facilities and service the Canadian market from this source. Only a guaranteed and secure access to the U.S. market, it is argued, will give firms the confidence they need to re-organize their Canadian production or build new plants within Canada.

(3) One alternative to the creation of a Canada-United States free trade area would be further tariff reductions under GATT. However, the large number of participants in GATT negotiations probably means that any such negotiations would be long drawn out affairs and concrete results might not accrue for at least a decade. In addition, negotiations tend to be dominated by the larger participants such as the U.S., the EEC and Japan. Canada's influence in such negotiations is comparatively small. Moreover, creation of a Canada-U.S. free trade area is not inconsistent with continued tariff reductions under GATT.

(4) Some 70 percent or more of Canada's trade is now with the United States and the trend in this percentage has been upward. In view of this it seems sensible to have a comprehensive agreement with the United States covering both tariffs and non tariff barriers rather having to rely almost completely upon arrangements negotiated under G.A.T.T.

(5) A comprehensive agreement might well involve the creation of new joint U.S.-Canadian institutions to examine and settle disputed issues. As a result many of Canada's recent problems in her trade with the United States involving hogs, potatoes, sugar, lumber, carbon steel and other products either would not arise at all or could be examined and settled under joint agreed procedures.

In evaluating the significance of a free trade area for the people of Manitoba it is useful to examine briefly recent developments in Canada's trade and what this seems to foreshadow for the future. As the data in Table 1 show there has been a strong growth in both our exports and imports relative to GNP since the early sixties. For exports the share of GNP reached in 1984 was a new high. For imports peak levels were reached in 1981. This suggests that the depressed level of domestic demand is currently keeping imports down and may also be responsible for the new high in the exports to GNP ratio.

TABLE 1

GROWTH IN CANADIAN TRADE, 1953 to 1984

| | 1953 | 1963 | 1973 | 1983 | 1984 |
|---|---|---|---|---|---|
| | | | (Percent of GNP) | | |
| Exports of Goods & Services | 20.8 | 19.7 | 24.9 | 27.7 | 31.3 |
| Imports of Goods & Services | 22.5 | 20.8 | 25.1 | 27.5 | 31.1 |
| Balance on Current Account | -1.7 | -1.1 | -0.2 | +0.2 | +0.2 |
| Commodities Only | | | | | |
| Exports | 16.1 | 15.4 | 20.6 | 23.3 | 26.7 |
| Imports | 16.3 | 14.3 | 18.4 | 18.7 | 21.8 |
| Commodity Balance | -0.2 | +1.1 | +2.2 | +4.6 | +4.9 |
| Services Net Balance | -1.5 | -2.2 | -2.4 | -4.3 | -4.7 |
| Interest and Dividends | | | | | |
| Percent of Service Balance | (64) | (63) | (42) | (53) | (57) |

Source: Statistical Summary: Bank of Canada, Various issues.

When commodities only are considered, the data shows a much stronger growth for exports than for imports. However, this is almost fully counterbalanced by the stronger growth in imports of services. Almost two-thirds of the service deficit represents net interest and dividend payments on foreign capital borrowed abroad or invested in Canada. The strong growth in exports undoubtedly reflects the general decline in tariff levels including the effects of the auto-pact.

When we examine the detailed commodity export position (see Table 2) we find some evidence of a longer term decline in the importance of resource based exports and a fairly strong growth in the importance of manufactured goods. Thus, exports of agricultural, fisheries and forest products have declined significantly relative to GNP since 1953. By 1984 agricultural and fishery based exports were just over sixty percent of the share of GNP that existed in 1953 and exports of forest based products had declined by about one-fourth relative to GNP. On the other hand, exports of crude oil and natural gas, a completely new export since 1953, now amount to about two-thirds the value of farm and fishery based products. Other mining exports, a group which covers a wide variety of different products, although fluctuating from year to year, show a general upward trend over the three decades from 1953 to 1984. The largest growth has occurred in

TABLE 2

Canada's Exports of Commodities, 1953 to 1984

| | 1953 | 1963 | 1973 | 1983 | 1984 |
|---|---|---|---|---|---|
| | | (Percent of GNP) | | | |
| Agriculture and Fisheries | 4.9 | 3.2 | 2.7 | 3.0 | 2.9 |
| Forest Products | 5.0 | 4.0 | 3.7 | 3.4 | 3.7 |
| Crude oil and natural gas | 0.0 | 0.7 | 1.5 | 1.9 | 2.0 |
| Other mining* | 3.5 | 4.0 | 3.9 | 4.3 | 4.8 |
| Chemicals and fertilizers | 0.5 | 0.6 | 0.6 | 1.1 | 1.3 |
| Motor vehicles and parts | 0.3 | 0.2 | 4.3 | 5.5 | 7.0 |
| Manufacturing and miscellaneous | 1.8 | 2.5 | 4.0 | 3.9 | 5.0 |
| Total | 16.0 | 15.2 | 20.6 | 23.3 | 26.7 |

*Includes electricity.

manufactured goods. Exports of these increased from 2.0 percent of GNP in 1953 to 12.0 percent in 1984. Of this latter total, autos and auto parts accounted for 7.0 percent in 1984 compared with virtually zero in 1953.

Since supply considerations make the prospects for further growth in the agricultural, fishery and forest based area somewhat limited, this data suggests that the growth in Canada's exports over the years ahead will increasingly be dependent on the manufacturing sector.

Concern has often been expressed about Canada's declining share of world trade. Such a decline seems paradoxical in view of the strong growth in Canadian exports relative to GNP. But it is true, as the data in Table 3 show, that Canada's share of world exports has fallen from 6.1 percent in 1953 to 4.6 percent in 1983. On the other hand, Canada's share of the exports of all industrial countries has remained fairly constant since 1963 and as a ratio to total U.S. exports Canadian exports have increased from 29.0 percent in 1953 to 38.3 percent in 1983. Thus, changes in the overall Canadian share of world exports do not suggest any cause for serious concern. Some of the changes in world share for different groups reflect such factors as the very large oil price increase after 1973, the formation of the European Economic Community with its resultant growth in intermember

TABLE 3.

Changing Export Shares, Selected Groups, 1953 to 1983

| | 1953 | 1963 | 1973 | 1983 |
|---|---|---|---|---|
| | (Percent of World Exports) | | | |
| Canada | 6.1 | 4.9 | 5.0 | 4.6 |
| United States | 20.9 | 17.0 | 13.6 | 12.1 |
| All Industrial Countries | 69.1 | 74.0 | 76.4 | 68.6 |
| Oil Exporting-developing | 6.2 | 6.2 | 7.4 | 10.5 |
| Non-oil developing | 24.5 | 19.5 | 15.4 | 19.4 |
| Canada as Percent of All Industrial | 8.8 | 6.7 | 6.6 | 6.7 |
| Canada as Percent of U.S.A. | 29.0 | 28.9 | 37.1 | 38.3 |

Source: I.M.F. International Financial Statistics, Various Issues.

trade and the rapid growth in output and/or population in the developing world, in Japan, in a number of members of the EEC and for the newly industrializing countries.

Creation of a free trade area eliminating both tariff and non-tariff barriers falls short of a complete economic union in two important respects. First, even with such an agreement movement of labour and capital would not be unrestricted. This is particularly true for labour since both Canada and the United States now impose significant restrictions on immigration. Second, since each country has its own currency there can be substantial fluctuations in the relative value of the two currencies over a period of time and these fluctuations can sharply affect the competitive position of each country's firms in their neighbour's market. A free trade area also differs from both an economic union and a customs union in that under a free trade area each partner retains its own tariffs on non-members. Let us consider the matter of exchange fluctuations in more detail.

One measure of the underlying value of the Canadian dollar is what economists call the "purchasing power parity index". While different price indexes have been used as a basis for the calculation of this "PPP index", the broadest measure of prices and the one used

here is the "implicit price of GNP". The implicit price index of GNP measures changes in prices of all the components of GNP including capital goods, exports and the value of goods and services purchased by all levels of government in addition to consumer goods and services. Unlike most other indexes the effects of import prices are netted out. The rise in the average price of GNP has its counterpart on the cost side in the incomes that makeup the income and product side of the national accounts.

Chart 1 shows a comparison of such a "purchasing power parity index" for Canada and the United States compared with the price of the U.S. dollar in Canadian funds. One would expect these two series to move generally in the same direction since when Canadian prices rise more than U.S. prices this should be reflected in a depreciation in the value of the Canadian dollar and a rise in the Canadian dollar cost of U.S. funds. Over the period from 1950 to 1972, as the Chart shows, the implicit price indexes of GNP in the two countries showed about the same degree of increase with the result that the PPP index (the Canadian price index divided by the U.S. index) varied over a narrow range. However, since 1972 the Canadian implicit price index of GNP has shown a much larger increase than the comparable U.S. index with the result that the PPP index moved from 105 in 1972 to 134 in 1984. While this much greater price increase in Canada has not been fully explained by economists, one plausible cause may be the much greater importance of resource based products in the Canadian economy. These products including oil and natural gas were subject to very large price increases in international commodity markets during the post-1972 period. For this reason the Canadian economy was subject to much stronger inflationary pressures than was true of the United States in this period.

A comparison of the PPP index with the price of the U.S. dollar in Canadian funds shows that, while the two indexes follow the same broad general pattern, the relationship has not been close. If we consider the period from 1962 to 1969 as a period when the Canadian

economy enjoyed a high level of prosperity, partly because of an appropriate exchange rate level, it is clear that both throughout the fifties and again over the entire period from 1972 to 1984, the value of the Canadian dollar was less favourable both to Canadian exporters, whether of resource based products or manufactured goods, and to Canadian firms who compete with imported goods. A value of the Canadian dollar today (June 1985) which would provide Canadian producers with the same competitive position that existed on average over the period from 1962 to 1969 would be $1.00 Canadian equal to 72.4 cents U.S. The present value of the Canadian dollar is very close to this. In terms of Chart 1 the corresponding value would be $1.00 U.S. equal to $1.38 Canadian.

The fact that the value of the Canadian dollar may diverge significantly for sustained periods of time from the PPP rate may be one reason why a Canadian manufacturer, who is heavily dependent on the U.S. market, might prefer to have his manufacturing operations located in the United Stated rather than in Canada. These fluctuations in the competitive position of a Canadian based manufacturer are an additional risk not faced by the comparable U.S. based firms.

An alternative but less comprehensive measure of the relationship which exists between the exchange rate and the competitive position of Canadian firms is provided by the data presented in Chart 2. This chart shows the movement in unit labour costs for Canadian and U.S. manufacturers with both series expressed in U.S. funds. The picture presented is similar to that shown in Chart 1. Canadian unit costs were relatively lower over the period 1962 to 1970, markedly less favourable during the 1950's, from 1972 to 1977 and again in 1982 and 1983. As of 1983, to restore the same competitive position Canadian manufacturers enjoyed during most of the 1960's would have required a depreciation in the value of the Canadian dollar of about 8 percent.

The above analysis of the exchange rate has concentrated exclusively on the value of the Canadian dollar relative to the U.S. dollar. Over the decade 1975 through 1984, some 69.9 percent of

Canada's commodity exports went to the United States and 70.6 percent of our imports came from that market. For the remaining 30 percent of Canada's commodity trade the relative movement of prices and exchange rates may have diverged from the pattern shown in Charts 1 and 2. However, it is the Canada-U.S. exchange rate which would be most relevant in considering the merits of a Canada-U.S. free trade area.

The divergence shown in Chart 1 between a purchasing power parity exchange rate and the value of U.S. funds in terms of the Canadian dollar is related in large degree to the flow of savings and investment in the Canadian capital market and to the demands placed by this market on foreign capital markets. A simple macro-economics equation used by economists equates the sum of exports of goods and services (X), government expenditures on goods and services (G) and gross private investment (I) to the sum of imports of goods and services (M), government tax and other revenues net of transfers ($T^n$) and gross private sector savings (S). Thus, we have:

$$X + G + I = M + T^n + S$$

and re-arranging we obtain:

$$(X - M) + (I - S) = (T^n - G)$$

In these equations I include capital expenditures made by crown corporations. The components of this last equation are shown in Table 4.

The primary driving force in the capitalist enterprise economy consists of the capital expenditures of the private sector and crown corporations. If these capital expenditures exceed private sector savings the balance may be financed in either of two ways. It could be financed by borrowing funds in foreign capital markets and using these funds to finance an excess of imports over exports. Or, if the government sector chooses to run a surplus, it could be financed by borrowing the funds thus made available. Table 4 provides a picture by 5 year periods of how this balance was achieved over the 38 year period from 1947 to 1984.

As the data show, in two periods, 1947 to 1951 and again from 1967 to 1971 the government was the primary balancing factor. Government sector surpluses in these periods provided all or most of the

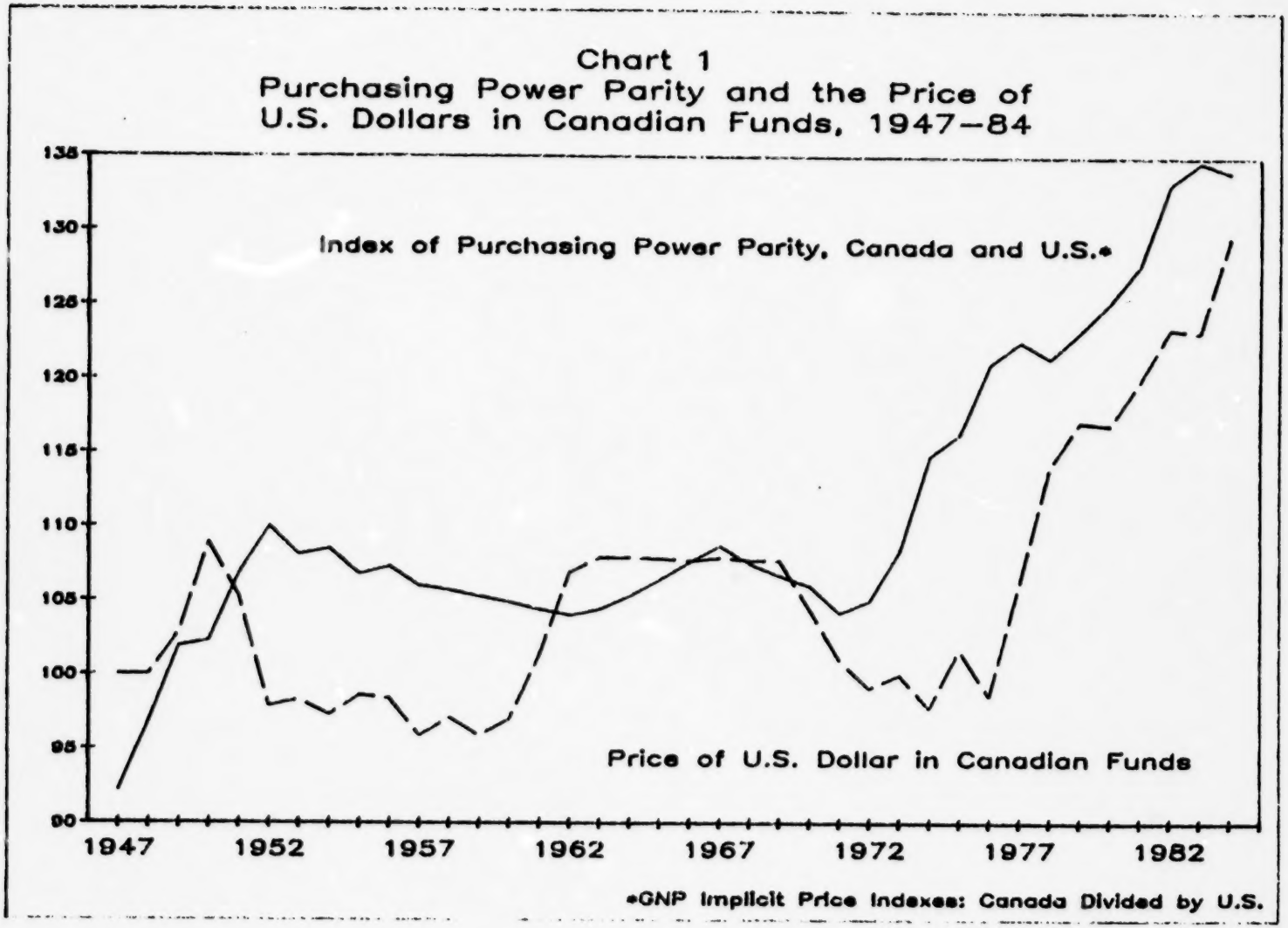
Chart 1
Purchasing Power Parity and the Price of
U.S. Dollars in Canadian Funds, 1947–84
Index of Purchasing Power Parity, Canada and U.S.*
Price of U.S. Dollar in Canadian Funds
135
130
125
120
115
110
105
100
95
90
1947
1952
1957
1962
1967
1972
1977
1982
*GNP Implicit Price Indexes: Canada Divided by U.S.

Chart 2
Unit Labour Costs in Manufacturing, Canada and the U.S.
both expressed in U.S. Dollars, 1947–83
Index, 1971=100

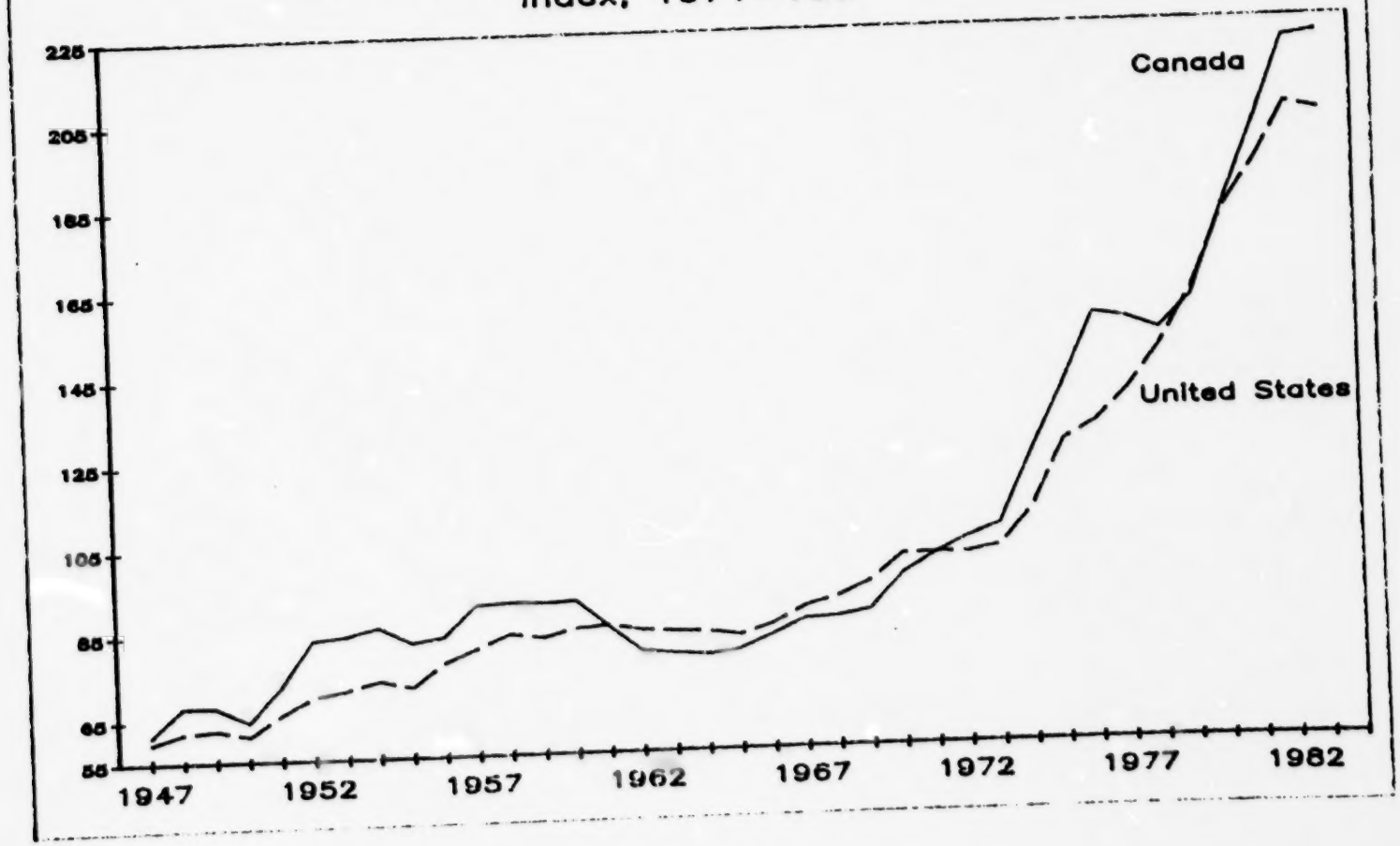

TABLE 4

Achieving a Balance Between Investment and Saving, Canada, 1947 to 1984

| | X - M | I - S | $T^n$ - G | |
|---|---|---|---|---|
| | (Percent of GNP, Annual Averages) | | | |
| 1947-51 | -0.0 | +3.3 | +3.3 | |
| 1962-56 | -1.8 | +1.9 | +0.1 | |
| 1957-61 | -3.2 | +1.9 | -1.2 | Excess use of foreign capital |
| 1962-66 | -1.6 | +1.3 | -0.3 | |
| 1967-71 | -0.2 | +1.5 | +1.2 | |
| 1972-76 | -1.5 | +1.2 | -0.3 | Excess use of foreign capital |
| 1977-81 | -1.9 | -0.4 | -2.4 | Excess use of foreign capital |
| 1982-84 | +0.3 | -6.4 | -6.0 | |

Source: Calculated from data in National Accounts, Statistics Canada.

added savings required by the private sector. In most other periods there was a substantial resort to the use of foreign savings. However, in three of the periods, 1957-61, 1972-76 and 1977-81 foreign borrowing substantially exceeded the funds required to achieve balance in the private sector. This meant that foreign funds were being acquired to finance a government sector deficit. These periods have been designated as involving an excess use of foreign capital.

In each of these periods there is some relation between the level of the exchange rate, the amount of foreign borrowing and the government's monetary and fiscal policy. In each period a lower value of the Canadian dollar would have encouraged an increase in exports and a reduction in imports, in effect, a lower net use of foreign borrowing. When the value of the Canadian dollar has been free to fluctuate in response to market forces, as was true from 1951 to 1962 and again since 1970, an easier monetary policy combined with a tighter fiscal policy will tend to lead to a smaller net capital inflow and smaller balance of imports over exports. At the same time the tighter fiscal policy produces a smaller government sector deficit or a larger government surplus. This would have been the appropriate policy response in the periods designated as involving an excess use of foreign capital. Finally, it should be noted that in the last

three years of this period, 1982 to 1984, for the first time the private sector showed a large surplus of savings over investment. This huge private sector surplus has been the primary cause of the large government sector deficit. Only this large deficit has prevented a further large decline in income and increase in unemployment.[1]

In inflationary periods managing monetary and fiscal policy in order to achieve an appropriate level of the exchange rate and a suitable level of foreign borrowing is more difficult. This difficulty arises from the fact that any depreciation in the value of the Canadian dollar tends to increase the price of exports, imports and goods competitive with imports. This provides an upward push to the price level similar to that provided by other cost push forces such as a rise in energy prices or an upsurge in food prices. To be effective the exchange depreciation may have to be combined with some form of incomes policy during such periods.

It is sometimes argued that any depreciation in the value of the Canadian dollar should be avoided because it would lead to a worsening of Canada's terms of trade and thus impose a real loss of income upon the Canadian economy. However, the effects of exchange rate depreciation upon a country's terms of trade are by no means certain. Where a country is comparatively small, the price of both its exports and imports and hence its terms of trade are set in world markets independently of the level of its exchange rate. In these circumstances, changes in the exchange rate will have no effect upon a country's terms of trade. To a large extent this may be true for Canada. However, for some products Canada may be a large enough supplier to affect the world price of her exports. On the import side, it seems unlikely that Canada can have a significant effect on the prices of the goods and services she imports. Thus, overall there is reason to believe that the effects of changes in Canada's exchange rate upon her terms of trade are comparatively small. This suggests that possible effects upon terms of trade should not be a consideration in determining the appropriate level of Canada's exchange rate.

In recent years, Canadian firms and individuals have constantly been told that they must strive as never before to become or remain competitive. The latest technology must be adopted. Individuals must work harder. They must acquire up to date skills and knowledge. All this is the result of the rapid pace of technological advance and new competition from many parts of the world. A group of countries such as South Korea, Taiwan, Malaya, Singapore and Hong Kong, labelled the Newly Industrializing Countries or simply the N.I.C.'s are responsible for some of this new competition. But many other countries participate as well. Japan, in the forefront in developing and adopting new technology threatens to decimate the old long established North American automobile industry. It is responsible for a constant flow of new high technology products in many other areas as well. Brazil, Mexico, Nigeria and many other countries are now providing manufactured goods at very competitive prices. And China, with its huge population, is showing signs of participating more actively in world markets.

Many of these countries have much lower wages than prevail in Canada and the United States. To some Canadian manufacturers it seems almost impossible to pay North American wage levels and still compete. Canadian trade union leaders call for something they call "fair trade". This seems to imply placing some limits on the flow of goods from these countries because their manufacturers pay "excessively" low wages, often face little or no environmental restrictions, are given special tax treatment and may even receive government subsidies. Even Canada's traditionally strong resource industries now face keen competition from products being dumped on world markets by developing countries hard pressed to obtain the foreign exchange needed to meet the interest and amortization payments due on their huge debts. And Canadian agriculture, which at one time had a large export market for wheat and other products in Western Europe, now faces stiff competition from the heavily subsidized farm products of the European Economic Community, competition which has recently been accentuated by the increase in the value of the U.S. dollar relative to European currencies.

How does one square this picture with the traditional one given by the theory of comparative advantage? According to this theory trade must be viewed as a two-way street. If low wage countries export more textiles, clothing and television sets to Canada they will use the Canadian dollars they obtain in this way to buy more Canadian goods. From the viewpoint of comparative advantage, all Canadian business firms, crown corporations, governments and other government institutions are competing with one another for Canada's productive factors, that is, its labour, capital and natural resources. As long as all employers of these productive factors compete on an equal footing within Canada, Canada can continue to trade advantageously with the rest of the world. According to this view, Canadian firms are not faced so much with keeping up technologically with similar firms in other countries but with other Canadian firms in other industries or parts of the country.

The view of this theory is, however, a long run view. If Canadian copper mines suddenly find their traditional markets disrupted because several developing countries are dumping copper on world markets, temporary losses will be imposed on our mines and mine owners. If long established textile firms or automobile producers find themselves faced with a flood of low priced imports from Japan, the N.I.C.'s, or from low wage China, the owners and employees in the Canadian industry will face immediate losses. If the copper mines or textile mills are located in one industry towns, the economic readjustment imposed by this competition may be long, slow and painful. This pain and cost may include the loss of social capital in the form of houses, schools, hospitals and other capital infrastructure as well as the sudden obsolescence of human skills and the loss of community relationships. Unless employment opportunities are developing elsewhere in Canada, the individuals involved may face long term unemployment. Even where the increased foreign competition is long term in character and will lead eventually to a higher real income to Canadians, it can have a disruptive effect on the Canadian economy because it affects some firms and industries much more than others. Thus, the increased rate of change in the world outside of Canada can impose far reaching changes within the country.

Two ultimate protective or at least palliating factors here are an appropriate level of the exchange rate and a strong level of domestic demand. Imported goods which are offering severe competition to Canadian producers at the existing exchange rate may be much less competitive if the Canadian dollar is depreciated by 10 percent or 20 percent. Even a relatively high value for a domestic currency as is true for the U.S. dollar throughout the world today may be less disruptive if the level of domestic demand is sufficiently strong. This seems to be one saving factor for the U.S. economy. Despite a current account deficit of $91 billion in 1984, some 2.5 percent of GNP, the United States has maintained an unemployment rate of just over 7 percent, almost 4 percentage points lower than the Canadian rate.

The above analysis is relevant to the proposed Canada-United States free trade area in the following respects. Even if we grant that over the long run increased trade as a result of new foreign competition will raise Canadian living standards, in the short run it may impose harsh re-adjustments upon particular industries and localities. Thus, the proposed creation of a Canada-United States free trade area comes at a time when the Canadian economy is already undergoing substantial re-adjustment to new competitive pressures from other countries. The proposal calls for a gradual reduction in tariffs in the two countries. One suggestion is for Canadian tariffs to come down over a ten year period while U.S. tariffs would be reduced by larger steps over a five year period. For many industries these tariff reductions might be no larger than those which took place and are taking place as a result of the tariff reductions agreed to at the Tokyo round of GATT negotiations. Still the re-adjustments required of Canadian workers and business firms would be in addition to those already taking place as a result of new international competitive forces.

What kinds of safeguards could be provided by the "free trade area" agreement? The "auto-pact" contained provisions tying Canadian

production levels in some ratio to sales of automobiles in the Canadian market. Could similar provisions be included in a "free trade area" agreement? It seems unlikely. The whole basis of a free trade arrangement covering at least 80 percent of all tradeable goods is the assumption that each country would be free to adjust its production into products or product lines in which it was most efficient. This might require substantial increases in some industries and products and significant reductions for others. The experience in the E.E.C. during its formative stages suggests that much of this adjustment took the form of increased specialization within industries rather than across industries. Thus, each country retained a broad range of industries but became more specialized in the product range it produced in each. Given the similarity of tastes and production conditions in Canada and the United States it seems probable that this would be the type of development which would result from the creation of a Canada-United States free trade area.

Perhaps the most significant overall protection or safeguard would be that provided by keeping the value of the Canadian dollar at a comparatively favourable level such as the value relative to the U.S. dollar that existed throughout the 1960's. Any evidence of a significant loss of employment and income in manufacturing could be offset by some further depreciation in the value of the Canadian dollar. It is particularly important that a protective exchange rate policy be pursued during the adjustment period when Canadian tariffs and non-tariff barriers against U.S. goods were being reduced to zero.

In an earlier section of this report the view was advanced that over any longer run period, Canadian exporting firms and Canadian firms that compete with imports should be viewed as competing with Canadian firms generally for labour, capital and other resources. Any excessive or undesired rise in imports relative to exports can be moderated through some deliberate depreciation in the value of the Canadian dollar. In terms of this view there is no reason why the Canadian tax structure, social policy or labour legislation should be

changed to make it harmonize with comparable aspects of the U.S. economy. As long as all Canadian firms, whether exporters, firms competitive with importers or firms catering entirely to the domestic market are trated uniformly, the U.S. will have no basis for a complaint that Canadian export firms are deriving any unfair advantage. To use the technical term, it is specificity that causes distortions in trade flows, that is, government subsidies or special tax advantages to firms engaged in export industries or to firms competing with imported products.

Employment Aspects of Foreign Trade

Concern has frequently been expressed about the loss of potential employment Canada may suffer through its foreign trade. Thus, the Canadian Labour Congress has recently argued that "our trade deficit in manufactured products was approximately $21 billion in 1983, which amounts to the loss of some 200,000 jobs." And there is an often repeated contention that because Canadian exports are so heavily concentrated in the area of raw material or only partially processed goods there is a corresponding loss of employment in Canada. A related argument has emphasized that exports of fully manufactured goods may provide more high quality jobs.

It is not clear that these concerns are valid. Despite her heavy import of manufactured goods and her large export of natural or raw products, over the three decades ending in 1981 Canada enjoyed the most rapid growth in employment of any country in the world. Even exports which are highly capital intensive and provide relatively little employment in their production provide Canada with the foreign exchange needed to purchase in foreign markets a wide range of goods which could not be produced in Canada at all or only at significantly higher costs. These exports often provide as well substantial tax revenues to governments and return to investors. Consider for example, Canada's current export of some $8 billion worth of oil and natural gas. Some of the income received from these exports accrue to

governments and may be used to employ people in the provision of various services such as education, hospitalization and medical care. A substantial part of the remainder may be reinvested in the industry on a continuing basis thus providing employment in the oil and gas drilling and servicing industry.

It is difficult to reach firm conclusions on this issue because economic theory provides no clear answers. The determinants of the rate of growth of employment is a neglected topic in economic theory. My own view is that a country can accommodate many different structures of foreign trade. Some countries who are major exporters of manufactured goods such as Western Germany and the United Kingdom have had a relatively slow growth in employment. In contrast, Italy and Japan, also exporters of manufactured goods, have experienced relatively rapid employment growth[2]. The two countries with the most rapid growth in employment, Canada and Australia, both export primarily resource based products. In the final analysis, employment in any country is primarily dependent on a strong level of domestic demand. Domestic demand, in turn, depends on a high level and steady growth in capital spending in relation to the economy's savings rate. Capital expenditures are often heavily oriented to anticipated growth in demand and this growth can occur in either the domestic market or the export market.

A number of economists have argued that a movement towards freer trade is needed to stimulate a revival in economic growth. They point to the fact that over the three decades from 1945 to 1975 there was almost continuous and at times rapid growth sparked by the substantial reductions in trade barriers under G.A.T.T. and the creation of major customs unions and free trade areas. Yet the causal relation here is far from certain. Does freer trade stimulate economic growth or is it rather economic growth that facilitates the movement to freer trade? Or are the two inter-related? For there can be little doubt that rapid growth and rising living standards makes it easier politically to negotiate reductions in tariff barriers and

facilitates the adjustments which the freer trade imposes. It may be significant that the major tariff reductions negotiated in the Tokyo round under G.A.T.T. and due to be completed by 1987 have shown little sign of stimulating any strong revival in economic growth. Economic growth is strongly dependent on the strength of capital spending and there has been virtually no growth in this area in industrial countries taken as a group since 1973. If the nations of the world would place more emphasis on stimulating a revival in economic growth and rather less on encouraging freer trade they could create an environment in which a movement towards freer trade would become both politically and economically more feasible.

What economic effects could we expect as the result of the creation of a Canada-U.S. free trade area? What would be the effects of such an arrangement upon Canadian employment, real income, volume of trade and other economic variables? How would the Manitoban economy be affected? There can be no doubt that a good deal of uncertainty exists as to what these effects would be. Estimates of different economists vary substantially and the economic basis on which these estimates are made are far from precise. To a very substantial degree the creation of such an entity requires a "leap of faith" on Canada's part. Let us consider briefly the history of economic estimates in this field.

As part of his work for the Gordon Commission Professor J. Young estimated that the removal of the Canadian tariff would add about 3.5 percent to the real income of Canadians[3]. This estimate was arrived at by comparing Canadian prices of all products imported with the price in their country of origin. The difference between these two prices net of the tariff was applied to the volume consumed. This was considered to give an estimate of what Viner had called the "cash cost of the tariff", or the amount Canadians could have saved if they had been able to import the goods duty free. A few years later Professor Paul and Ron Wonnacott added to this an estimate of how much Canada would benefit if the U.S. tariff against Canadian

goods were removed as well[4]. They argued that free trade with the United States would enable Canadian manufacturing industries to re-organize for sale in the U.S. market. The economies of scale they achieved in this way would increase Canada's real income by about 6 percent according to their estimate. Thus, the creation of a Canada-U.S. free trade area, they argued, would increase Canada's real income by between 10 and 11 percent. Their estimate did not involve any detailed industry by industry estimate but was based on the simple assumption that Canadian productivity levels in manufacturing would rise to U.S. levels and this would increase Canadian wage levels by an amount equal to 6 percent of Canadian output. This, when added to Young's estimate of 3.5 percent which they raised to 4.5 percent, gave them their estimate of 10.5 percent.

Since that time the size of the Canadian market has grown substantially, real national product in Canada increased 3.5 times between 1954 and 1984, and there has been a major reduction in Canadian and U.S. tariff levels. In particular, the creation of the U.S.-Canada auto pact has resulted in a major transformation of the auto and auto parts industry.

The Wonnacott estimate has been criticized on the grounds that productivity levels depend on many factors besides economies of scale. These factors include the quality of management, the education level of the labour force, the promptness with which new technology is adopted, costs related to climatic factors and even the pace of work. Thus, there is no presumption that free trade would cause productivity levels in Canadian manufacturing to rise to U.S. levels.

The most recent estimate of the effects of bilateral free trade between the U.S. and Canada is contained in a major monograph and several supplementary papers by Richard Harris[5]. Harris constructed an applied general equilibrium model which incorporates assumptions with respect to economies of scale and imperfect competition. Using tariff levels in effect about 1971 and making estimates as to the

tariff equivalent of non-tariff barriers he estimated that the complete elimination of tariff and non-tariff barriers between Canada and the U.S. would increase Canada's real income by about 9 percent. This result is largely dependent on the assumption that the increased specialization of Canadian manufacturing which would result from increased exposure to U.S. competition and access to the U.S. market would yield quite large economies of scale. The U.S. economy is assumed to be much more competitive than the Canadian economy and this forces Canadian firms to rationalize their operations thus obtaining economies of scale which they currently forego because in the less competitive Canadian environment a larger number of firms can survive, their higher per unit costs being passed on in higher prices to the consumer.

Harris's model also projects a 5.5 percent increase in employment in Canadian manufacturing and an overall increase for the Canadian economy of from 13 to 15 percent in labour income. Average labour productivity in all sectors is projected to increase by 30 percent. Average output per firm in manufacturing would increase by 224 percent and the number of firms would decline by almost one half. Canada's total trade with the United States would almost double.

Although the Harris model has received a good deal of attention, it seems clear that the results have some serious limitations which make it difficult to assess what validity to attach to the results. In particular:

a) Estimates of economies of scale are highly uncertain and may in fact be lower than Harris assumes.

b) Since many of the same multi-national firms operate in both Canada and the United States and a few firms may dominate many major industries there can be no presumption that removal of the U.S. tariff will make all Canadian manufacturing industries competitive. In the farm machinery industry free trade between the two countries appears to have had little effect on concentration levels in the industry.

c) Because the model assumes full employment, no allowance is made for the possibility that some industries might simply disappear from the Canadian scene, their economic location in Canada being no longer competitive from the viewpoint of the North American economy as a whole. Within the United States, the share of total manufacturing has been increasing in the Southern and Western states. This pattern of growth raises doubts about the viability of Canadian plant locations over the long run in a free trade area.

d) As a result of the Tokyo round of tariff negotiations under G.A.T.T., tariff levels are now substantially lower than those incorporated in the Harris model. Thus, it is not clear how much of the Harris result is still applicable.

Some of the more detailed results of the Harris model raise some questions about the potentially disruptive effects of a free trade area. Employment is projected to decline 38 percent in furniture, 35 percent in non-agricultural machinery, 27 percent in farm machinery and 23 percent in electrical products. In contrast, employment is projected to increase by 259 percent in clothing, 150 percent in textiles, 48 percent in knitting, 59 percent in transport equipment and 31 percent in paper and allied products. Given the highly regional nature of some of these industries, changes of this size suggest the potential for a rather far reaching impact on employment in particular cities and towns. Moreover, some of the largest employment increases are in the industries most vulnerable to offshore competition.

It is also clear that a doubling in the volume of Canada-U.S. trade would greatly reduce the independence of Canadian fiscal policy. A greatly increased number of Canadian firms would become primarily dependent on demand levels in the United States rather than in Canada. At the same time, changes in Canadian demand levels which might result from a Canadian fiscal stimulus might have their major impact upon employment in the United States. Federal fiscal policy

would find itself faced with many of the limitations that confronts provincial fiscal policy today.

A More Detailed Look at the Harris-Cox Model

A comparison of the Harris model with an alternative estimate obtained from a University of Michigan model underlines the range of uncertainty involved in estimates in this field[6]. Both models use data in 1976 prices. The Harris model incorporates economies of scale effects and is based on 1971 tariff levels including an allowance for the tariff equivalent of non-tariff barriers. The Deardorff-Stern model excludes economies of scale effects and is based on 1987 tariff levels without any allowance for non-tariff barriers.

The Deardorff-Stern model estimates that multilateral free trade would increase world exports by $29 billion with Canadian exports increasing by just $1.7 billion. The Harris model estimates that multilateral free trade would increase Canadian exports alone by $44 billion. Much of this difference results from Harris's assumption that Canadian manufacturing industry would become much more specialized so that there would be a large increase in both Canadian exports and imports.

A sceptical view of the Harris results might well require answers to the following questions:

a) Why would the major multi-nationals who control access to technology equity capital and marketing channels choose to build new plants in Canada in the face of increasing wage rates and with falling profit margins? Might they not prefer to locate their new plants in Mexico or Brazil or Spain or any one of a number of other countries where wage rates are much lower than they are in Canada and where governments often provide generous incentives to induce the location of manufacturing plants in their country.

b) If foreign multi-nationals did not choose to make the new investments could we count on Canadian firms to have the expertise, technology equity capital and access to marketing channels needed to successfully carry through such a venture?

c) Harris's assumption that Canada has a perfectly elastic supply of capital available to her seems rather naive. Much of the capital required would be equity capital and this has always been in rather short supply and available only at increasing cost. Yet the model envisages very large capital investments. In one model where completely free trade is assumed capital imports into Canada are assumed to increase from $2.1 to $14.4 billion. Can we count on this kind of capital availability? The Canadian brewers have estimated that some $2 billion would be required to fund the rationalization of their industry if a Canada-U.S. free trade area were created. They suggest that this would require massive government funding.

d) The required rationalization of Canadian manufacturing would impose significant re-adjustments even on the large U.S. economy without the prospect of substantial U.S. benefits. In terms of 1985 prices the Harris model envisages an increase in U.S. imports from Canada on the order of $100 billion, much of it in particular industries. Is there any prospect that the U.S. would willingly accede to such a major re-adjustment to their economy?

e) Who would bear the re-adjustment costs? Presumably the major changes required would make significant amounts of existing capital obsolete. If the experience of the Auto-Pact is any guide, the major multi-nationals would require and be in a position to retain a substantial share of the benefits from increased economies of scale, particularly during the period when the new investments were being made.

f) The assumption that all the productivity gains that accrue from economies of scale would accrue to labour in the form of higher wages or to Canadian consumers in the form of lower prices seems questionable. Even if this were true in the longer run, in the short run many of these firms might be in a position to supply the Canadian market from existing plant capacity. It is reported that the U.S. brewing industry has excess capacity equal to about three times the Canadian market.

g) A number of Harris's results seem implausible or their basis has not been clearly explained. Thus, one of his papers shows a 20 percent increase in productivity and a 27 percent decline in employment in the agricultural equipment industry even when the industry already has almost completely free trade. Again the transportation equipment sector is assumed to double its output, increase its productivity by 27 percent and its employment by 59 percent even though the important automobile and parts industry already benefits from a free trade arrangement. Or to take another instance, there seems to be no allowance for industries which are essentially local in their orientation because of transport costs or the need for prompt delivery. Thus, one sees no reason to expect any change in the way potato chips are produced in Edmonton or the way the Winnipeg Free Press is printed. The study makes no reference to transport costs or the trade-off that may be imposed by them.

To sum up, a sceptical view of the Harris model might well conclude that the potential benefits to the Canadian economy from a U.S.-Canada free trade area are exaggerated and that the transitional adjustment costs underestimated. The Macdonald Commission estimated the benefits of a Canada-U.S. free trade area as being in the range of 3 to 8 percent. The above analysis suggests that the gains may be closer to the lower end of that range rather than the higher end.

Present Tariff Levels

In arriving at some assessment of the effects to be expected from the creation of a U.S.-Canada free trade area it is necessary to make some evaluation of the tariff levels that will exist as of 1987, the year in which the Tokyo round of tariff reductions will be completed. By 1987 it is estimated that the U.S. average tariff on imports subject to duty will be about 4 to 5 percent, similar tariffs in Japan and the European Economic Community will be from 5 to 7 percent and Canadian average tariffs will be from 9 to 10 percent. At that time, it has been estimated that about 80 percent of Canada's exports to the U.S. will enter duty free, a further 15 percent will encounter duties of 5 percent of less and only 5 percent will face still higher duties. However, these data can be misleading since if the duties above 5 percent were removed there might be a substantial rise in the volume of exports in these sectors. In some sectors U.S. tariffs are still relatively high and for some products even a tariff of 2 or 3 percent can be high enough to prevent the development of a resource processing industry in Canada because the effective tariff rate on value-added may be much higher than this.

A better indication of 1987 tariff levels in Canada and the United States are those provided by so-called basket clauses in tariff schedules. These are tariff items designed to cover manufactured products not yet developed or classified, usually specified on the basis of the products material content. The average 1987 rate for this category covering 7 different items was 10.2 percent for Canada and 5.5 percent for the United States. The range of rates for Canada was from 9.2 to 13.5 percent and for the U.S. from 3.7 to 6.6 percent. These are nominal rates. Effective rates on value-added could be expected to be somewhat higher than this. Still, these rates are very much lower than those which prevailed at the end of World War II.

Conclusion

What are Manitoba's interests in a Canada-U.S. free trade area? In what ways might her people and industries gain or lose?

Several economic studies have examined the regional impact of the Canadian tariff. A study by Shearer, Young and Munro published in 1971 estimated that as of 1963, a North Atlantic free trade area would have increased the income of British Columbia residents by about 5.5 percent[7]. About one-third of this gain was related to the higher prices paid on tariff protected goods produced in British Columbia. Most of the remainder reflected the higher prices paid for goods produced in Ontario or other parts of Canada. Since that time the Canadian market has increased in size, Canadian tariffs have declined and the auto-pact has greatly reduced the relative price of automobiles. Thus, if this estimate were being updated as of 1987, it would be much lower than 5.5 percent, perhaps in the range of 2 to 3 percent. The authors did not think there would be a significant effect on the amount of employment in British Columbia.

In a more recent study for the Economic Council of Canada, using data for 1969, Hugh Pinchin estimated that a bilateral free trade arrangement with the United States would cause a loss of manufacturing employment of about 1.2 percent[8]. For the Prairies he placed the loss at just 0.7 percent. These estimates did not make any allowance for the effects of production and employment gains as a result of economies of scale made possible by access to the large U.S. market and made only limited allowance for possible trade diversion effects. Trade diversion would occur if Canadian firms increased their sales in the United States at the expense of third countries.

Applying these data to Manitoba one can anticipate a gain to provincial residents in the range of 2 to 3 percent of income as a result of lower prices for manufactured goods. The effect on employment in Manitoba's manufacturing industries is more difficult to assess. The Harris study anticipates strong gains in production and employment in clothing, textiles, transport equipment and paper and allied products. Even if these gains are less than estimated some of

these industries in Manitoba might make significant gains with tariff free access to the huge U.S. market. It is possible that after the adjustment period was complete employment gains in Manitoba's manufacturing might be as large as or larger than the employment losses that might occur for particular firms or sectors.

What Attitude should the Government of Manitoba take towards the creation of a free trade area between Canada and the United States? Should it give its support to this proposal or opt for some more limited arrangement such as Sectoral Free Trade or a Comprehensive Agreement with respect to non-tariff barriers? No clear and unequivocal answers can be given to these questions. The following are some of the key questions that must be weighed in arriving at an answer.

(1) Any far reaching agreement such as one for a free trade area may well involve going down a road from which there is no turning back. It is likely to be a long term perhaps even a permanent arrangement. Canadians will need to understand the issues fully with all their implications before they decide. A more limited arrangement could more easily be reversed or significantly modified.

(2) Although there have been numerous studies of the probable effects of the creation of a free trade area, there is still a good deal of uncertainty as to what the outcome would be.

(3) Over the shorter term, the creation of a Canada-U.S. free trade area could lead to increased unemployment in Canada. Such an outcome might be averted if a strong revival in growth and capital spending occurred during the period the agreement was coming into effect. In many respects current economic circumstances are very unfavourable for the implementation of such an agreement. The strong rise in the value of the United States dollar over the past few years has given manufacturers throughout the world a strong competitive position in the U.S. market. In addition, because of the Tokyo round tariff reductions, U.S. tariffs are now quite low on many manufactured goods. Thus, Canadian manufacturers would be faced with opening up

their traditional markets in Canada to U.S. competition while trying to gain a foothold in the huge U.S. market with new more specialized products. Moreover, they would be trying to gain this foothold in the face of almost unprecedentedly severe competition from manufacturers in the rest of the world, in the face of widespread excess capacity and in the presence of sluggish growth throughout the world. While over the long run this effort might be successful, over the next decade or more the adjustment problem faced by Canadian manufacturers and their workers might be severe.

(4) Some observers have argued that because of the huge size of the U.S. market it should be possible for Canadian firms to acquire market niches for their products. Yet as was pointed out above, the Harris model projects a doubling of Canadian exports to the United States. In terms of 1985 prices this implies an increase in Canadian exports of about $100 billion. This would involve an increase from 3 to 6 percent of the U.S. GNP. To achieve such an increase would require much more than a few or even many niches in the U.S. market. It would require major penetration of many important markets. For the U.S. this effect would be offset by an increased Canadian purchase of U.S. products. But the size of the trade adjustment required suggests the need for quite substantial adjustments within the U.S. market as well. How ready would Americans be willing to accept these adjustments and how would they affect Canada-U.S. relations? We simply do not know.

(5) It is sometimes argued that the relative ease with which the adjustment to increased inter-country trade occurred at the time the European Common market was formed supports the view that Canada's adjustment to the formation of a Canada-U.S. free trade area would not be difficult. However, there are important differences in the two examples. In the case of the E.C.M. some six different countries were making adjustments in their production specialization at the same time. In the Canada-U.S. example we face a situation where the major partner, the U.S., already has a production structure which is specialized for sale to a large market. It is Canada alone which must

re-orient her production facilities towards a larger scale more specialized structure. To do so she may have to impose re-adjustments upon the U.S. economy. Further, the formation of the E.C.M. occurred during a period of rapid economic growth throughout the world. This contrasts with the relative stagnation of recent years.

(6) On a more positive note it is clear that those Canadian manufacturers who survived in a more competitive market would be better equipped to survive over the longer term and to sell their products on a world wide basis. They would be producing fewer products on much longer production runs and the increased economies of scale obtained thereby would enable them to sell at lower prices. And as a result of the major investment needed to facilitate this major structural change they might well find themselves equipped with the latest manufacturing equipment and technology.

(7) If they are to agree to the formation of a Canada-U.S. free trade area the U.S. will expect substantial benefits of their own. Individual U.S. firms will benefit as a result of their improved and preferred access to the Canadian market but others will face increased competition from Canadian producers. As a percent of the U.S. GNP these benefits can be expected to be relatively small. Thus, to justify an agreement the U.S. will expect other benefits as well. What are they likely to be?

U.S. trade experts have expressed interest in services, the treatment of investment and restrictions on Canada's use of subsidies. They may also want better access to government procurement at all levels of government including crown corporations and may raise the issue of restrictions on advertising in border television stations and in some publications.

Up until now trade in services has not been covered by G.A.T.T. and attempting to include them in an arrangement may raise some complex issues. Much of the existing trade in services can be related to:

a) Services that are complementary or ancillary to trade in goods such as the transport, finance and insurance of goods moving from one country to another.

b) Services related to the existence of foreign ownership and control. In Canada's case this would include royalties for technology provided by the parent and payments for business or professional services provided to the subsidiary by the parent corporation. Some economists have criticized this flow of service payments as being prejudicial to the development of Canadian services in this area.

c) Services related to the movement of people between countries such as tourist expenditures and business travel costs.

An important question is how to distinguish between what is trade and what is simply foreign ownership and control of facilities in other countries. In this respect the desire for freer trade in services may simply be a desire for fewer restrictions on foreign ownership. It is sometimes argued that to facilitate trade in services there should be the right to set up an establishment in the trading partner. But if a U.S. bank, for example, has the right to set up an establishment in Canada, is this anything more than foreign ownership and not trade at all.

Related to trade in services are immigration regulations, particularly with respect to the right of workers to come into a country on temporary assignment, a phenomenon which may cover everything from stoop labour to professional engineers.

(8) There is some risk that the creation of a Canada-U.S. free trade area would result in a significant increase in U.S. ownership of manufacturing facilities in Canada. Because Canadian firms would have to undertake major structural changes in order to compete effectively in the large U.S. market, a number of the smaller independent companies might find it expedient to sell out to U.S. firms operating

in the same field. Such an arrangement could ease the problems involved in adjusting to the manufacture and sale of more specialized products since the U.S. firms would be more likely to have access to the finance, technology and marketing expertise required. Other independent firms might find themselves unable to make the adjustment required and simply close up shop. Still others might successfully make the transition to competing in the larger market.

It is also possible that some plants whose ownership is already in the U.S. or other countries would be closed. This could result in some reduction in foreign ownership. However, where a firm's present Canadian operations give them access to an experienced and skilled labour force supported by a good social and economic infrastructure it seems likely that the foreign owner would transform his operation into the more specialized one needed to sell in the larger market. Indeed, under the impact of the latest round of G.A.T.T. tariff reductions a number of foreign owned plants in Canada have already moved to a more specialized basis of operation sometimes involving world product mandates assigned by their parent company.

(9) In examining Canada's prospects under a Canada-U.S. free trade area it is always useful to ask the question "What is the worst that could happen?" One unfavourable outcome would be a decline in the size of the Canadian manufacturing sector and a reduction in its growth rate over the longer term. Such a development could leave a residue of persistently high unemployment rates in many cities and towns lasting for a decade or more. Perhaps the best way to avoid such an outcome would to ensure that the exchange rate was kept at a level which would at least partially offset the unfavourable effects of the decline in the Canadian tariff and that there was an adequate provision for adjustment assistance for both firms and individuals.

Recommendation

I would recommend that the Government of Manitoba support a proposal that Canada enter into negotiations with the U.S., the object being the formation of a comprehensive agreement aimed at eliminating most tariffs and non-tariff barriers between the two countries. To

qualify for G.A.T.T. approval a free trade area would have to cover about 80 percent of trade between the two countries, thus there would be some margin for exempting areas or products considered to be particularly vulnerable or of cultural importance. The recommendation should be conditional upon:

a) Canada having the freedom to use her exchange rate to offset any significant adverse effects upon her manufacturing industry as a whole and

b) the creation of a substantial fund to assist firms and individuals who would be required to make substantial adjustments or undergo significant hardships as a result of the agreement.

In evaluating the various points outlined above I am anticipating that the present high value of the U.S. dollar in world markets will not persist for more than a year or two beyond 1985. In the context of a 10 year adjustment period for Canadian firms this should not be a serious matter. In addition, I believe Professor Harris has significantly overstated the size of the adjustment in Canada-U.S. trade which will be required. It seems likely that Manitoba's manufacturing sector as a whole should be able to adjust to free trade with the United States without undergoing serious hardship. However, individual firms may well disappear or face severe difficulties. The results of the Department's recent survey of a sample of larger firms seem to support this conclusion.

While on balance I have come down on the side of forming a free trade area, it is not an easy decision to make and I would respect the views of those who, giving different weights to the various issues, reached the opposite conclusion. For I do not believe that Canada's economic future depends critically on choosing the free trade option. A continuation of the policy that has served us well since 1945, one of negotiating a gradual move towards freer trade through G.A.T.T., is a perfectly viable option.

In many discussions of free trade in the popular press there has been a widely held belief that negotiation of a free trade arrangement would somehow lead to a revival of economic growth. A revival in Canada's economic growth is long overdue but no one has clearly established the link between a move to freer trade and economic growth. Some scepticism with respect to this view would be fully justified.

Clarence L. Barber
August 26, 1985

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## REFERENCE FOOTNOTES


1 See C.L. Barber, "Thinking about the Deficit and the Recent Poor Performance of the Canadian Economy", Western Economic Review, December, 1984, pp.1-6.

2. Average Annual percentage growth in employment for the 7 major industrial countries over the decade 1967-76 was as follows: Canada 2.7, U.S.A. 2.0, Japan 0.9, France 0.7, West Germany 0.2, Italy 1.6, United Kingdom 0.3. See World Economic Outlook, April, 1985, International Monetary Fund, Table 4.

3. John H. Young, Canadian Commercial Policy (Ottawa: Queen's Printer, 1957).

4. Ronald Wonnacott and Paul Wonnacott, Free Trade Between the United States and Canada: The Potential Economic Effects (Cambridge, Mass.: Harvard University Press, 1967).

5. See Richard G. Harris with David Cox. Trade, Industrial Policy and Canadian Manufacturing, Ontario Economic Council, 1983 and Richard G. Harris, "Summary of a Project on the General Equilibrium Evaluation of Canadian Trade Policy", in Canada-United States Free Trade, Vol. 11, prepared for the Royal Commission on the Economic Union and Development Prospects for Canada (Toronto: University of Toronto Press, 1985).

6. See Alan V. Deardorff and Robert M. Stern, "The Economic Effects of Complete Elimination of Post Tokyo Round Tariffs", W.R. Cline ed., Trade Policy in the 1980's, Institute for International Economics, Washington, 1983, 673-711.

7. R.A. Shearer, J.H. Young and G.R. Munro, Trade Liberalization and a Regional Economy: Studies of the Impact of Free Trade on British Columbia (Toronto: University of Toronto Press, 1971).

8. Hugh McA. Pinchin, The Regional Impact of the Canadian Tariff (Ottawa: Minister of Supply and Services, 1979).

DISCUSSION PAPER

# A COMPREHENSIVE FREE TRADE AGREEMENT BETWEEN CANADA AND THE UNITED STATES

## An Analysis of the Potential Economic Impact with Particular Reference to the Manufacturing Sector in Manitoba

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The views expressed in this paper are those of the author. They do not necessarily reflect the views of Manitoba Industry, Trade and Technology.

# A Comprehensive Free Trade Agreement Between Canada and the United States

Free trade is an ancient issue. Much of Adam Smith's Wealth of Nations (published 210 years ago) was concerned with demonstrating the advantages of unrestricted commerce over mercantilism. And Smith was only the most famous, not the first, to argue that point. In the years following the publication of the Wealth of Nations, the theory of free trade was elaborated by individuals such as David Ricardo--who set out the principle of comparative advantage--and since then a large majority of economists have held the advantages of free trade to be among the most important and least controversial tenets of economic theory.

The surprising thing is that free trade should be so heartily and unanimously advocated by economists, and so little practiced by governments. The advantages of free trade are said to be very substantial; given also the fundamental assumption underlying most of economic theory--that economic agents behave rationally--it is puzzling that most governments, usually at the behest of capital and labour, have opted for protection. It would seem either that the assumption of rationality of economic agents is not very robust, or that the relative costs and benefits of free trade are not what economic theorists would have us believe. The problem is not that governments have been unwilling to give free trade a try. Great Britain adopted unilateral free trade in the 1840's, but eventually returned to protectionism. Canada and the United States signed the Reciprocity Treaty in 1854, which provided for free trade in natural products, but the treaty was abrogated by the U.S. only eleven years later. A more recent example, the European Economic Community, has survived for more than two decades, but its success has not led it to seek much in the way of expanded, global free trade.

Richard Harris and David Cox, in a recent study for the Ontario Economic Council, make a point which may provide at least part of the explanation for the gap between economic theory and economic policy:

> . . . the embarrassing fact is that the importance attached to free trade by economists is often a belief hammered into them by years of training based on a tradition of analysing the inherent virtues of resource allocation by the unfettered hand of the free market, as handed down by Smith, Ricardo, and other great classical economists. This 'belief' translates into the assertion that it is 'self-evident' or 'well established' that free trade is a major source of economic growth and welfare. This claim is made by most economists, certainly by most academic economists responsible for teaching in universities. One of the points we wish to make in this book is that, by the conventional standards of evidence in economics, the claim is not well-founded. . . . That is not to say there is no evidence, only that the 'case for free trade' does not rest on the same kind of objective standards that a proposition such as 'stimulative aggregate demand causes inflation if the economy is fully employed' rests on. [1]

Harris and Cox, it should be noted, are themselves advocates of free trade.

A similar point has also been made recently by another economist, Harry Bloch. He argues:

> . . . empirical studies of the impact of tariffs in Canadian manufacturing have been obsessively focused on demonstrating the negative consequences of protection, often neglecting the opposite implications of the statistical results. Current proposals for trade liberalization in Canada are based on this combination of incomplete theorizing and biased empirical studies. [2]

The economics profession probably cannot take much credit for the recent resurgence of interest in trade liberalization, and in particular for the conversion of many manufacturers from their traditional protectionist stance to support for freer trade. But economists provide much of the credibility associated with proposals for liberalized trade, and in light of the suggestion from Harris and Cox, Bloch, and others that the profession has considered the issue less carefully than it should have, it is important to re-examine the arguments and evidence for free trade. One reason why it is important is that if we have unrealistically high expectations of the gains to be achieved from trade liberalization, we may end up giving away too much in the negotiations. [3]

Estimates of the Gains from Free Trade

The costs and benefits of protection were being debated in Canada long before Confederation. However, it was only in relatively recent times that attempts were made to estimate those costs and benefits empirically. The first attempt was made by John Young for the Royal Commission on Canada's Economic Prospects in 1957. Young estimated only the "cash cost" of the tariff: the amount by which the real income of Canadian consumers was reduced because they had to pay tariff-inflated prices. He concluded that unilateral removal of Canadian tariffs would raise the real income of Canadians by 3.5 percent.

A decade later the brothers Wonnacott made the first calculation of the benefit to Canada of a reduction in U.S. tariffs. Because of access to a larger market and the consequent economies of scale, productivity in Canada would rise closer to U.S. levels and real incomes would rise by six percent. They added this to Young's estimate and concluded that "free trade could eventually increase Canadian income by over 10 percent". [4] In later studies the Wonnacotts refined and improved their estimates but still arrived at an answer in the same range as their earlier study. [5]

Over the last decade there have been several more attempts by J.R. Williams, B. Hamilton and J. Whalley, and others, to estimate the impact of free trade. Each employs different assumptions or methods, but as far as the present author is aware, non of the estimates is negative. (There are those who argue that Canada will lose from a free trade arangement, but none have prepared an empirical estimate of the amount by which GNP might decline.) The lowest estimate so far is from the study by Hamilton and Whalley, which concluded that GNP would rise by only 1.3 percent. [6] Even this low estimate is, as Lipsey and Smith have pointed out, equivalent to a once-and-for-all addition to Canada's capital stock of between $135 and $270 billion. [7]

Perhaps the most significant effort in this field is the recent effort by Harris and Cox. Their book has been described by John Whalley as "undoubtedly one of the most important pieces of applied research to

be done on a Canadian policy issue for many a year", and by the Institute for Research on Public Policy as "one of the most important contributions to Canadian economics in the last decade". [8] The reason for this high praise is two-fold. First, Harris and Cox have constructed a general equilibrium model with emprically-derived estimates of many of the principle variables. This means that the results reflect the ramifications for the rest of the economy of a change in one sector, such as a reduction in the tariffs on manufactured goods. These secondary effects can be quite significant, but most economic modelling is based on partial-equilibrium analysis: the rest of the economy is held constant. Economists well know that the general equilibrium approach is the "correct" one, but it is extraordinarily unwieldly. The work of Harris and Cox represents one of the very few attempts to employ this method.

The second noteworthy feature which distinguishes Harris and Cox is their incorporation of two assumptions which are often missing from economic work: economies of scale and imperfect competition. While economies of scale were implicit in the work of Wonnacott and Wonnacott, other authors such as Williams and Hamilton and Whalley have assumed constant returns to scale.

Despite these improvements in method, Harris and Cox come up with results that are consistent with the earlier estimates. Initially, Harris and Cox applied their model to <u>multilateral</u> free trade and found that real income would rise by 8.6 percent of GNE. Most of this increase is due to improved productivity: aggregate output per person rises 33 percent. [9] However, some of their results on an industry-by-industry basis are counter-intuitive, which raises questions about the overall results. In particular, the clothing industry does unbelieveably well. In spite of the conventional wisdom that this industry would be among the first to fall if it was not protected from imports from the low-wage countries, Harris and Cox predict that exports of clothing would rise by 3,165 percent. Of course, the current volume of exports is not large, so it doesn't take too much of an absolute increase to obtain a large percentage increase. Even so, output in the clothing industry rises by 68 percent, although employment rises by only 4 percent. The reported

increase in labour productivity is 62 percent--much more than in any other of the 29 industries covered. [10] There is no elaboration on this in the text.

Harris and Cox subsequently applied their model to the question of bilateral free trade between Canada and the United States. [11] Again, their result is in the same ballpark: the net welfare gain from bilateral free trade is equal to 9.0 percent of GNP. The bilateral case results in greater benefits than the multilateral case due to trade diversion: goods which Americans might have purchased in other countries are purchased in Canada because U.S. tariffs remain in force for other countries. Other results:

-real wages would increase 28 percent;

-labour productivity would increase 30 percent;

-average output per firm would increase 224 percent, while the number of firms would decline by 46 percent--in other words, there would be half as many firms but the survivors would be three times as big;

-employment would increase 5.5 percent;

-7 percent of the labour force would have to change jobs;

-the volume of Canada-U.S. trade would double;

-out of 22 manufacturing sectors, output would decline in 5 and increase in 17, but employment would decline in 13 and increase in 9.

The detailed results by industry are presented in Table 1. As in the multilateral case, the results for the clothing industry are hard to believe: employment increases 259 percent and output increases 478 percent. The next biggest increase is in textiles (156 percent increase in employment, 239 percent increase in output). The third biggest increase in terms of output is in knitting mills: 107 percent. Even though these industries would continue to be protected against competition from the low wage countries under bilateral free trade, it is hard to imagine that they would leave all other industries behind in the dust; the average increase in output for the other 19 manufacturing industries is only 22 percent. Results that are so strongly counter-intuitive call into question the validity of at least some of the assumptions underlying the model.

Table 1

Estimates by Harris and Cox of the Changes in Output, Employment and Productivity in 22 Manufacturing Industries that Would Result from Canada-U.S. Free Trade

(percent change from base case)

| | Output | Employment | Productivity |
|---|---|---|---|
| Clothing | 478 | 259 | 61 |
| Textiles | 239 | 156 | 33 |
| Knitting | 107 | 48 | 40 |
| Transportation Equipment | 101 | 59 | 27 |
| Urban Transportation Equip. | 61 | 28 | 26 |
| Paper and Allied | 60 | 31 | 22 |
| Rubber | 37 | 5 | 31 |
| Printing | 35 | 13 | 20 |
| Tobacco | 28 | -10 | 42 |
| Food and Beverages | 25 | -2 | 27 |
| Leather | 24 | -8 | 35 |
| Petroleum | 24 | -8 | 34 |
| Chemicals | 23 | 0 | 22 |
| Steel | 21 | -1 | 23 |
| Non-Metalic Minerals | 21 | -1 | 23 |
| Wood | 15 | -13 | 31 |
| Metal Fabricating | 14 | -8 | 23 |
| Electrical | -2 | -23 | 27 |
| Agricultural Equipment | -12 | -27 | 20 |
| Furniture | -16 | -38 | 36 |
| Miscellaneous Manufacturing | -18 | -33 | 22 |
| Non-Agricultural Machinery | -19 | -35 | 23 |

Source: Cox and Harris, "A Quantitative Assessment of the Economic Impact on Canada of Sectoral Free Trade with the United States," Toronto: Ontario Economic Council Working Paper, 1984. Reproduced in Institute for Research on Public Policy, "Economic Effects of Trade Liberalization with the USA" (A paper prepared for the Department of External Affairs, May, 1985), p. 77.

Aside from doubts about the size of some of the industry estimates in the work of Harris and Cox, there have been a number of criticisms levelled at their work as well as the estimates produced by their predecessors. The most significant concerns assumptions about productivity. The Wonnacotts explicitly assumed that under a free trade regime, productivity in Canada would rise to U.S. levels. This is the source of the increased output they predicted. As Table 1 shows, Harris and Cox also expect large increases in Canadian productivity. The assumption is that with access to a much larger market, firms will produce longer runs of fewer product lines and thereby achieve economies of scale. Furthermore, Canadian firms are shielded from foreign competition by the tariff and can afford to be less efficient to a degree proportional to the tariff. Removal of the tariff would increase competition and force firms to increase productivity.

Bruce Wilkinson has pointed out that even after 118 years of free inter-provincial trade in most goods and services, there are still very large, unexplained productivity differences between Canada's provinces. [12] He cites one study which examined productivity in 20 industries and found that average difference between the most and least productive provinces in each industry was 72 percent. Some individual differences were as high as 206 percent. [13] If free trade between provinces hasn't equalized productivity, can we expect free trade between Canada and the U.S. to do so?

Wilkinson also points out that the farm machinery industry has enjoyed tariff-free access to the U.S. market for many years and yet has not achieved American levels of productivity. Similarly, there are no tariffs on Canada's large volume of newsprint exports to the U.S., but the industry includes a large number of small, obsolete plants. [14]

More generally, we may consider the impact of the increase in exports that has occurred over the past decade. This has largely been due to the increase in the value of the U.S. dollar, and so it is not equivalent to trade liberalization because it has tended to reduce rather than increase competitive pressures in the Canadian economy. But

it has certainly provided for expanded sales in the U.S.; since 1976, the real value of our total exports has increased by 60 percent. However, between 1976 and 1983, real Gross Domestic Product per person employed--the broadest measure of productivity--actually decreased by about half a percentage point. In manufacturing alone, the volume of exports of motor vehicles and parts rose about 45 percent, other manufactured exports rose about 55 percent, and real value added per person employed in manufacturing increased by only six percent over the same seven year period. It could be that firms considered their increased sales in the U.S. to be a temporary phenomenon due to the high U.S. dollar, and therefore did not undertake any productivity-increasing investment. But who's to say they won't also take a wait-and-see attitude towards a free trade agreement--after all, the last one (the Reciprocity Treaty of 1854) lasted only 11 years. It could also be that the increased exports merely compensated for reduced domestic demand, but perhaps the same situation will persist even under a regime of liberalized trade.

The Wonnacotts have responded to the productivity issue by arguing that "the case for free trade does not depend on eliminating a productivity gap. If the gap is only cut by, say, one half, the economic case for free trade is still a strong one." [15] However, the evidence above suggests that the assumption of increasing productivity because of free trade is a weak one. What empirical evidence is there that the productivity gap will be cut by even one-half? This point is important: the studies by the Wonnacotts and Harris and Cox purport to be empirical estimates of the impact of free trade, but the estimates rest on an assumption with no empirical basis. On the contrary, the evidence above is consistent with an alternative hypothesis that free trade will have very little impact on Canadian productivity. The implication is that Canada cannot enter an agreement for liberalized trade and then just wait for productivity to rise. We will have to make sure that it rises. If we can't figure out how to do that, then there is a case to be made for holding off on negotiating trade liberalization.

Another factor to keep in mind when considering estimates of the benefits of free trade is the period for which the estimates are

relevant. The Harris and Cox estimates are derived from data for the mid-'seventies, including the tariff data. Because of the reductions that have occurred subsequent to the Kennedy and Tokyo rounds of the GATT negotiations, tariffs are now much lower than they were in the mid-'seventies. Hence, the benefits that remain to be captured will amount to less than nine percent. For the sake of discussion, let us assume that free trade with the U.S. will now generate a further five percent increase in real GNP. Since any liberalization of trade would be phased in over ten years, we could only expect GNP to increase each year by about half a percentage point more than would be the case if we maintained the status quo. Given that, over the past ten years, the average amount by which real growth rates varied from year to year was 3.4 percentage points, there is no way we will notice whether or not we have obtained our extra half a point of growth or not. In other words, we may never even notice the benefits of free trade, even if they do occur. It is worth considering whether the problems associated with free trade will be equally invisible.

In the same vein, it should be noted that free trade would not likely be the solution to our unemployment problem that some people expect it would be. Harris and Cox estimate that employment would increase by 5.5 percent under Canada-U.S. free trade. If this estimate, like the growth estimate, is reduced to account for the trade liberalization that has taken place since the mid-'seventies, then we can expect only a two or three percent increment in employment over the course of a decade. Furthermore, the persistent increase in our unemployment rate from 5.3 percent in 1974 to ten or eleven percent now has occurred in spite of a 65 percent increase in exports over the same period, and an improvement in our trade balance from a $2 billion deficit in 1974 to a $6.6 billion surplus in 1984 (expressed in 1971 dollars).

The final point to be made here with respect to the gains-from-free-trade estimates concerns the expected behaviour of firms. All the estimates that have been made are technical in the sense that they are based on an assumption that firms will take advantage of opportunities available to them. In other words, it is assumed that if a firm is given

access to a much expanded market, and the fundamental competitive conditions are appropriate, that firm will make the necessary investments and restructuring in order to increase output and achieve economies of scale. At first glance, it seems that any other behaviour would be perverse, and has therefore been largely ignored. But the response of firms to freer trade may not be as straight-forward as it seems.

Consider the branch plants of American firms that account for roughly half of Canadian manufactured output. Many if not most of them were established to produce and sell in Canada the same products that their parent produces and sells in the U.S. It is unlikely that many of these firms would expand their operations in Canada in order to sell into the U.S. market the same products already marketed by the parent. No doubt, some firms will meet growing U.S. demand for their product by expanding their Canadian plants, and others may do what the auto manufacturers and Black and Decker have already done: rationalize their production so that each plant, whether in the U.S. or elsewhere, specializes in only one or a few products. But these may be offset by other firms that close their Canadian operations and supply this market from their current excess capacity in the U.S. (Canadian brewers, for example, have pointed out that excess capacity in the U.S. brewing industry is equal to 3.3 times total Canadian production. U.S. brewers could meet the entire Canadian demand for beer by increasing output ten percent, and still have 17 percent excess capacity. [16])

Someone remarked recently that "anyone who says U.S. branch plants will shut down and pull out because of free trade is engaging in scare tactics". Perhaps, since it is not too likely that a significant number of foreign firms will walk away from their investments in Canada. But that is not quite the issue. The more important question is: will they expand in order to sell into the U.S. market and thereby achieve the economies of scale and productivity increases from which the benefits of free trade are said to flow?

There may be other reasons why business would not respond to free trade in the manner expected by those who estimate the gains from free

trade, reasons that are not obvious a priori. It was our feeling that this was a major gap in the large body of work that has been done on free trade. Manitoba Industry, Trade and Technology decided to address this issue by conducting a survey of Manitoba manufacturers. The objective of the survey was to find out how the firms that make up Manitoba's manufacturing sector think they would be affected by free trade between Canada and the U.S., and how they would respond.

Survey of Manitoba Manufacturers

There are approximately 1,500 manufacturers in Manitoba, but only 485 of these have more than 20 employees. We decided to limit our survey to firms with 20 or more employees because many of the small "manufacturers" are bakeries and print shops serving local markets and enjoying "natural" protection from imports. Moreover, we know that small firms are much less likely to export than are larger firms, and so they are less likely to take advantage of tariff-free access to the U.S. market. Furthermore, both the birth rate and the death rate of small firms is high, so that opportunities which do open up for small firms as a result of free trade are just as likely to be exploited by firms which do not now exist as by existing firms.

A letter with our list of questions was sent from the Deputy Minister to the 485 largest manufacturers. We then phoned each of the firms to obtain their responses. Because we did not rely on firms to mail in their reply, and because there is considerable interest in the topic, we were able to obtain 391 responses. Thus, our survey covered a full 81 percent of the target population. The 391 respondents account for 78 percent of total manufacturing employment in Manitoba.[17]

Almost two-thirds of the respondents said they were in favour of trade liberalization with the U.S. However approximately one-fifth of these said that they favoured freer trade in principle, but thought that it would not be in the best interests of their own firm. Only 19 percent opposed trade liberalization, but most of these were vehement in their opposition. In contrast, few of the supporters were really enthusiastic. The remaining 18 percent were either indifferent or hadn't made up their

minds. On balance, we would have to characterize the collective attitude of Manitoba manufacturers as unethusiastic but supportive.

This interpretation is consistent with the results of other questions. While 30 percent of the respondents expect increased exports under a freer trade arrangement, 57 percent expect no change. With respect to sales in Canada, the 15 percent who expect an increase are outnumbered by the 20 percent who expect a decrease; 51 percent expect no change.

Of particular interest is the response to the question: How would you respond to free trade with the U.S.? The largest number of respondents--37 percent--said there would be no change in their operations. The next biggest group--30 percent--didn't know how they would respond. A healthy but unspectacular one-quarter said they would increase investment, as compared to only 3.8 percent who said they would terminate their operations. Out of 485 firms, a termination rate of 3.8 percent would translate into 18 closures, as compared to 118 firms which would increase investment. In other words, for every firm which goes out of business, 6 or 7 will expand their operations. (If the 117 firms who don't know how they will be affected fall out in the same proportions, 6 of them will close, 41 of them will expand and 62 will experience no change.)

Will the impact of the closures be outweighed by the expansion of those firms which will increase investment? One way to approach this question is to estimate the employment effects. Using somewhat imprecise data on employment by firm, we have estimated that free trade would result in the loss of 1,700 to 2,100 manufacturing jobs due to plant closures, which would be experienced as an average job loss of 170 to 210 per year over ten years.[18] The firms which will likely increase investment have between 12,000 and 17,000 employees. Thus, the latter will have to increase their employment by somewhere between 10 and 18 percent (one to two percent per year) to make up for the jobs lost through closures. This is probably not an unreasonable expectation.

Of course, part of the job loss would probably be made up by new firms established to take advantage of new opportunities opened up by trade liberalization. Other jobs lost in manufacturing would be replaced by new jobs in other sectors. The above estimate of job loss amounts to only 2.9 to 3.5 percent of total manufacturing employment in Manitoba, or less than half of one percent of total employment in the entire Manitoba economy.

The best we can say based on this survey is that free trade would not likely result in any net loss of jobs, but neither is there any evidence from the survey that there would be a significant increase.

In considering how firms would respond to free trade, it is interesting to note that most respondents seemed to consider only how the present configuration of each of their firms would fare. Only 8 of the 391 firms said they would switch product lines, and few had thought about how they might take advantage of new opportunities. Over time, as new opportunities become apparent, there may be more firms undertaking new investment than indicated above. On the other hand, it may be cause for concern that so few firms are thinking now about how they could benefit from free trade by reorganizing or changing their product lines.

One issue upon which the survey was intended to shed light was the reaction of foreign-owned firms to free trade. In some cases, we had difficulty determining where ultimate control lies, but this problem applied only to the smaller employers.

Of the 32 firms identified as being U.S. owned, six said they would increase investment if trade barriers were removed, and one said it would terminate operations. To put this in perspective, consider Table 2, where there is a very close correspondence between the proportion of firms in each ownership category, and the proportions which said they would either increase investment or terminate operations. Thus, the survey provides no evidence to support the hypothesis that foreign owned firms would react differently to free trade than Canadian owned firms. However, there is one caveat to keep in mind: it

Table 2

Ownership of Firms and their Response to Free Trade

| Ownership | % of Total Respondents | % of Firms which would Close Down | % of Firms which would Increase Investment |
|---|---|---|---|
| Manitoban | 74.2 | 73.3 | 76.8 |
| Other Canadian | 16.6 | 13.3 | 14.7 |
| American | 8.2 | 6.7 | 6.3 |
| Other | 1.0 | 6.7 | 2.1 |
| | 100.0 | 100.0 | 99.9 |

Note: Since only 15 firms said they would close down, 6.7 percent represents just one firm, and 13.3 percent represents two firms.

has been the experience of Industry, Trade and Technology that when the Manitoba branch of a national or multinational firm has been closed, the local management often has had no prior warning. Thus, our survey may not provide a true indication of the number of foreign-owned branch plants which might close down in response to trade liberalization.

In sum, as far as the manufacturing sector is concerned, it would seem that Manitobans have little to fear from free trade with the United States. There may well be significant benefits, but we have not found evidence that these will be as dramatic as some advocates maintain.

Should Canada Pursue a Comprehensive Free Trade Agreement with the U.S.?

In the previous sections of this paper, we have established two points:

1. The gains to be had from free trade have probably been overstated, or at least not sufficiently well established.

2. Manitoba's manufacturing sector as a whole will not likely suffer under free trade, and may well enjoy some benefits. However, there is no evidence that those benefits will be dramatic.

We have not considered the other sectors of the Manitoba economy. A study just prepared for the Prairie Pools concludes that western

agriculture would enjoy net benefits as a result of freer trade, but that some specific sub-sectors would suffer. We have not analysed the other primary sectors, but the general expectation is that they all stand to gain from freer trade. We have very little idea how the service sector would be affected.

In light of the above, it would seem that the potential benefits of trade liberalization are neither so certain nor so large that Canada can afford to pursue an agreement with the U.S. at all costs. What we can reasonably be expected to gain from an agreement, and what we will have to give up in order to get it, will have to be weighed very carefully.

It is likely that in any negotiations, the U.S. will raise certain issues that are not directly related to trade. For example, some Americans have stated that Unemployment Insurance, Medicare and regional development policies all provide unfair subsidies to Canadian firms. Canada's best response may be to insist on the principle that domestic policies such as Medicare and Unemployment Insurance are not export subsidies because all firms are treated equally. Both countries should also recognize that their respective regional and industrial development policies, though generally different in form, are equally legitimate. To abandon these and other domestic policies would simply be too high a price to pay.

While we expect some net benefits overall from trade liberalization, it remains that some particular industries will be hurt. Brewing, for example, is one industry which has argued that it would have difficulty adjusting to free trade. Under GATT, free trade agreements between two countries must cover at least 80 percent of the trade between those two countries. That means that up to 20 percent of the trade may be exempted. Canada should consider whether those industries which will suffer unduly should be exempted from any agreement.

Even in industries which do well overall under freer trade, some firms will go out of business. These firms were established in the

expectation that the protection they require would continue. If the rules are now changed, the firms which go bankrupt, and the workers who are thrown out of work, have a right to expect some form of adjustment assistance. This could include low interest loans to enable investment in alternative businesses, retraining or early retirement benefits for workers, and so on. Manitoba should consider establishing a committee of government, labour and business representatives to develop a strategy for helping workers and firms to adjust to trade liberalization.

While we have argued above that gains from trade liberalization have been overstated, it is equally true that some of the expectations of what the U.S. would be willing to give us in an agreement are excessive. One of the claims made for a comprehensive trade agreement, and indeed, one of the reasons why such an agreement is desired with such urgency in some quarters, is that it will exempt Canada from "the growing mood of protectionism in Congress". This is probably unrealistic. Consider, for example, the softwood lumber case. The demands of U.S. protectionists are based on the claim that Canadian practices give our producers an unfair advantage in the U.S. market. If a trade agreement was put in place, those interests would still argue that Canada was acting unfairly. They would also be able to argue that we were contravening the spirit, and possibly the letter, of the Canada-U.S. agreement. Indeed, if Canada seeks exemptions for some industries, as argued above, the U.S. may seek exemptions for the softwood lumber and other industries that have been a source of contention recently.

We should also try to keep U.S. protectionism in perspective. Very few Canadian exports have been threatened with U.S. import barriers, and even fewer have actually been subjected to restrictions. Canada has been quite successful at preventing import restrictions by presenting our case to U.S. authorities such as the International Trade Administration. In particular, several American investigations of the softwood lumber case have handed down decisions in Canada's favour. It is true that some Canadians, such as hog producers, have been hurt unfairly by U.S. actions, but cases such as this are isolated, especially when one considers the vast array of goods we sell to the U.S.

Nor should we ignore the fact that our trade surplus with the U.S. has increased by a huge amount. If our positions were reversed, and Canada was running a trade deficit of comparable proportions, there would certainly be a strong protectionist mood in Parliament. The more our trade surplus grows, the more loudly we demand enhanced and secure access to the U.S. market. The fact is that the U.S. has a serious problem, one which has worked in our favour. U.S. saw mills are closing down. U.S. steel workers have been put out of work by the thousands. Even if they misunderstand the causes of their problem, we can hardly blame them for being upset.

The current mood of protectionism is directly related to the present trade problem. That problem will not last indefinitely; when it passes, so will the demands for higher levels of protection. Thus, it may be unwise to view a potential trade agreement as mainly a defensive move to protect us against protectionism; we may end up with a solution for a short-term problem which has negative long-term repurcusions, if we are not cautious.

On the other hand, there may be benefits from a trade liberalization agreement which have so far been overlooked. Several prominent nationalists have become vocal opponents of trade liberalization, but they seem to have overlooked the possibility that freer trade could lead to a greater proportion of Canadian ownership in Canadian industry. One of the major reasons why U.S. firms have established branch plants here is to be able to sell behind our tariff wall. If that wall is dismantled, U.S. firms who want to sell here will no longer have to invest here. Whatever happens to existing branch plants, it is likely that there will be fewer new branch plants in the future. On the other hand, Canadians who want to establish firms will have a larger market to support their operations. Nor will they have to invest in the U.S.--as many have been doing recently--in order to sell there. It is quite possible that trade liberalization will lead to a reduction in cross-border direct investment in manufacturing.

In conclusion, there are sufficient grounds to believe that trade liberalization could benefit Canada that we should proceed to open at least exploratory discussions with the U.S. However, the benefits will probably be modest, so we can not afford to concede too much in negotiations. In particular, if the U.S. demands significant changes in our domestic policies, Canada should be prepared to leave the table and pursue instead further multilateral trade liberalization under GATT.

Perhaps we should also reconsider whether present Canada-U.S. trade arrangements are really so bad. Over the past decade our exports have increased by two-thirds and our trade balance has improved dramatically. We could hardly expect any more from a free trade agreement. Admitedly, the status quo presents us with a number of problems, but it may be premature to dismiss it altogether as an option.

Finally, much of the enthusiasm for free trade probably derives from frustration with the failures of our domestic economic policies. Unfortunately, it is highly unlikely that free trade by itself will generate full employment and a healthy growth rate. We still require improved fiscal, monetary and industrial policies. We should not let a desire for freer trade distract us from addressing this need.

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Notes

1. Richard Harris with David Cox, Trade, Industrial Policy, and Canadian Manufacturing (Toronto: Ontario Economic Council, 1983), p.2.

2. Harry Bloch, "Tariff Protection and Industrial Development in Canada," Western Economic Review 4 (March, 1985), p. 28.

3. This point is made by Bruce Wilkinson in "Canada-U.S. Free Trade and Some Options," Canadian Public Policy 8 (October, 1982), p. 432.

4. Paul Wonnacott and Ronald Wonnacott, U.S.-Canadian Free Trade: The Potential Impact on the Canadian Economy (Montreal: Canadian-American Committee, 1968), p. 44. This booklet is a summary of Free Trade Between Canada and the United States: The Potential Economic Effects (Cambridge: Harvard University Press, 1967).

5. The Wonnacotts review their estimates and some of the criticisms thereof in "Free Trade Between Canada and the United States: Fifteen Years Later," Canadian Public Policy 8 (October, 1982) pp. 412-427.

6. B. Hamilton and J. Whalley, Geographically Discriminatory Trade Arrangements (London, Ont.: University of Western Ontario, Department of Economics, November, 1983).

7. Richard Lipsey and Murray Smith, Taking the Initiative: Canada's Trade Options in a Turbulent World (Toronto: C.D. Howe Institute, 1985), p. 39.

8. John Whalley, 'Trade, Industrial Policy and Canadian Manufacturing . . .: A Review Article," Canadian Journal of Economics 17 (May, 1984), p. 387; The Institute for Research on Public Policy, "Economic Effects of Trade Liberalization with the USA" (A paper repared for the Department of External Affairs, May, 1985), p. 60.

9. Harris and Cox, pp. 114-5.

10. Harris and Cox, Tables 14 and 15.

11. The results for bilateral free trade were reported in two unpublished papers which are summarized in "Economic Effects of Trade Liberalization with the USA" (see note 8), pp. 69-79.

12. Bruce Wilkinson, op. cit., p. 429.

13. Ludwig Auer, Regional Disparities of Productivity and Growth in Canada (Ottawa: Economic Council of Canada, 1978).

14. Bruce Wilkinson, "Commercial Policy and Free Trade with the United States," Canada Among Nations, 1984: A Time of Transition ed. D.W. Tomlin and M. Molot (Toronto: James Lorimer, 1985), pp. 174-5.

15. "Free Trade Between Canada and the U.S.: Fifteen Years Later," p. 420.

16. Brewers Association of Canada, "Perspectives on Canada-United States Free Trade," (Submitted to the Honourable James Kelleher, Minister of International Trade, May, 1985), p. 2.

17. The phoning and the tabulation and analysis of the results were carried out (in excellent fashion) by Stuart Duncan and Garrett Wasny of Duncan Wasny Research.

18. We have not tried to estimate how many jobs would be lost in those firms which will experience a decline in sales, but stay in business. Nor have we tried to estimate how many jobs will be created by firms which experience an increase in sales, but plan to undertake no new investment.

SUMMARY

# THE IMPACT OF CANADA–U.S. FREE TRADE ON MANITOBA'S MANUFACTURING SECTOR: A SURVEY OF MANITOBA MANUFACTURERS

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September, 1985

## The Impact of Canada-U.S. Free Trade on Manitoba's Manufacturing Sector: A Survey of Manitoba Manufacturers

The following is a summary of the results of a survey of Manitoba manufacturing firms conducted by Duncan/Wasny Research Ltd. for Manitoba Industry, Trade and Technology. The survey was initiated as the result of a concern that too little is known about how manufacturers would respond to free trade between Canada and the United States.

The survey was limited to the 485 manufacturing firms with more than 20 employees. These firms account for 91 percent of total manufacturing employment in the province. Many of the firms with less than 20 employees are bakeries, print shops and the like, serving local markets and enjoying "natural" protection from imports. Furthermore, a rather small proportion of the small firms export their products. In view of these considerations, it was felt that little would be lost by excluding the small firms from the survey.

A letter was sent to each of the 485 largest manufacturers, and the firms were then phoned for their responses to our questions. We obtained 391 responses for a response rate of 81 percent. The 391 respondents account for 78 percent of total manufacturing employment in Manitoba.

| | No. | % |
|---|---|---|
| i) Location | | |
| Winnipeg | 328 | (83.9) |
| Outside of Winnipeg | 63 | (16.1) |
| ii) Number of Employees | | |
| 20 - 49 | 191 | (48.8) |
| 50 - 99 | 97 | (24.8) |
| 100 - 249 | 67 | (17.1) |
| 250 - 499 | 21 | ( 5.4) |
| 500 - 999 | 8 | ( 2.0) |
| 1000 + | 7 | ( 1.8) |
| iii) Ownership of firm | | |
| Manitoban | 290 | (74.2) |
| Other Canadian | 65 | (16.6) |
| American | 32 | ( 8.2) |
| Other | 4 | ( 1.0) |

1) Approximately what proportion of the value of your output is exported to the United States?

| | | |
|---|---|---|
| 0% | 189 | (48.3) |
| 1 - 19% | 131 | (33.5) |
| 20 - 49% | 44 | (11.3) |
| 50% + | 27 | ( 6.9) |

2) Are your products subject to U.S. tariff or non-tariff barriers?

| | | |
|---|---|---|
| Yes, tariffs | 169 | (43.2) |
| Yes, non-tariff | 8 | ( 2.0) |
| Yes, both tariff and non-tariff | 20 | ( 5.1) |
| No | 180 | (46.0) |
| Don't know | 14 | ( 3.6) |

3) If your products are subject to tariffs, please specify the rate.

| | | |
|---|---|---|
| 1 - 5% | 46 | (27.2) |
| 6 - 10% | 38 | (22.5) |
| 11 - 15% | 13 | ( 7.7) |
| 16 - 20% | 4 | ( 2.4) |
| 21 - 30% | 3 | ( 1.8) |
| 30% + | 5 | ( 3.0) |
| Don't know rate | 60 | (35.5) |

4) Are your products protected by Canadian tariff or non-tariff barriers?

| | | |
|---|---|---|
| Yes, tariffs | 209 | (53.5) |
| Yes, non-tariff | 6 | ( 1.5) |
| Yes, both tariff and non-tariff | 11 | ( 2.8) |
| No | 127 | (32.5) |
| Don't know | 38 | ( 9.7) |

5) If your products are protected by tariffs, please specify the rate.

| | | |
|---|---|---|
| 1 - 5% | 22 | (10.5) |
| 6 - 10% | 39 | (18.7) |
| 11 - 15% | 34 | (16.3) |
| 16 - 20% | 13 | ( 6.2) |
| 21 - 30% | 10 | ( 4.8) |
| 30% + | 4 | ( 1.9) |
| Don't know rate | 87 | (41.6) |

6) Suppose that Canadian and American tariff and non-tariff barriers were gradually eliminated over a ten year period.

a) How would this affect your exports?

| | | |
|---|---|---|
| No change | 222 | (56.8) |
| Increase | 117 | (29.9) |
| Decrease | 8 | ( 2.0) |
| Don't know | 44 | (11.3) |

b) How would this affect your sales in Canada?

| | | |
|---|---|---|
| No change | 199 | (50.9) |
| Increase | 57 | (14.6) |
| Decrease | 79 | (20.3) |
| Don't know | 56 | (14.3) |

c) How would you respond?

| | | |
|---|---|---|
| No change | 146 | (37.3) |
| Increase investment | 95 | (24.3) |
| Terminate operations | 15 | ( 3.8) |
| Switch product lines | 8 | ( 3.0) |
| Other | 10 | ( 2.6) |
| Don't know | 117 | (29.9) |

7) How does the present low exchange rate of the Canadian dollar relative to the U.S. dollar affect your business?

| | | |
|---|---|---|
| Helps | 196 | (50.1) |
| Hurts | 88 | (22.5) |
| Not significant | 86 | (22.0) |
| Don't know | 21 | ( 5.4) |

8) Would you purchase more of your supplies from the U.S. if Canadian import barriers were reduced?

| | | |
|---|---|---|
| No | 211 | (54.0) |
| Yes | 140 | (35.8) |
| Don't know | 21 | ( 5.4) |

9) Would the cost of supplies you know import be reduced?

| | | |
|---|---|---|
| Yes | 186 | (47.6) |
| No | 168 | (43.0) |
| Don't know | 37 | ( 9.5) |

10) Would you consider making an arrangement with a U.S. firm (eg. technology licensing, merger) in order to survive without protection?

| | | |
|---|---|---|
| No | 219 | (56.0) |
| Yes | 71 | (18.2) |
| Don't know | 101 | (25.8) |

11) If yes, provide an example.

| | | |
|---|---|---|
| Joint operations | 53 | (13.6) |
| Acquisition | 5 | ( 1.3) |
| Merger | 2 | ( 0.5) |
| Technology licensing | 1 | ( 0.3) |
| Don't know | 10 | ( 2.6) |

12) Are you in favour of trade liberalization with the United States, opposed to trade liberalization, or indifferent?

| | | |
|---|---|---|
| In favour | 245 | (62.7) |
| Opposed | 76 | (19.4) |
| Indifferent | 28 | ( 7.2) |
| Don't know | 42 | (10.7) |